RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 •

POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038
26 LETTERS PER YEAR • $225 ANNUALLY

Dec. 31, 1986 **LETTER 955**

Dec. 19 DJIA 1928.85; PTI 2450; A-D Ratio -7.50
Dec. 26 DJIA 1930.40; PTI 2439; A-D Ratio -7.82

THE PICTURE: There's a LOGIC in the stock market. It's the world's most illusive logic, but it's there. Sometimes I get a hint of that logic, and sometimes I'm convinced that I've grasped a large piece of it. It's the search for that logic that keeps me going in this business, and I swear that uncovering the logic of Wall Street is more satisfying to me than any amount of money that I might make (although success in uncovering the market's logic invariably leads to making money).

The logic of the market is almost always visible in retrospect. But it's the puzzle of what the market is saying today, and what it might be saying about tomorrow, that for 35 years has taken up my days and occupied my dreams. Some people claim that the market is a "random walk," and that no amount of study and no system can make sense of Wall Street. In my guts, I know they're wrong. The market possesses a logic as surely as plants grow and as surely as the sun rises. I know this intuitively.

All right, Russell, back to reality, back to the real market. This (as you may have guessed) is a most unusual market. The stock market has had to deal with a major technical problem throughout most of 1986. That statement may sound mysterious to neophytes, but I can assure you that what I am going to discuss next is important to the further progress of this bull market.

What I am talking about basically has to do with market PRICE -- as measured by the various stock averages, and market BREADTH -- as measured by the advance-decline ratio (the A-D ratio measures the advancing and declining tendencies of all the stocks on the NYSE). So here we go, and I hope I can make the following discussion clear to my subscribers.

First, if you study the history of the stock market you will note that the MARKET LIKES HARMONY. In a perfect bull market everything would advance together (i.e, the various averages, the A-D ratio, the most-actives, the high–lows, bonds, etc.). By the same token, in a perfect bear market, everything would go down together. Of course, we never have perfection in the stock market. We occasionally get close, but perfection -- never.

One of the really important market relationships is that of price and breadth. When the AVERAGES (which measure price) go up, we want the MAJORITY of issues (as measured by the A-D ratio) to go up too. That's an example of very desirable market harmony. On the other hand, when price and breadth diverge, for instance, when the averages advance and the A-D ratio refuses to follow, we can look for trouble or at the least we can look for an erratic and confusing market.

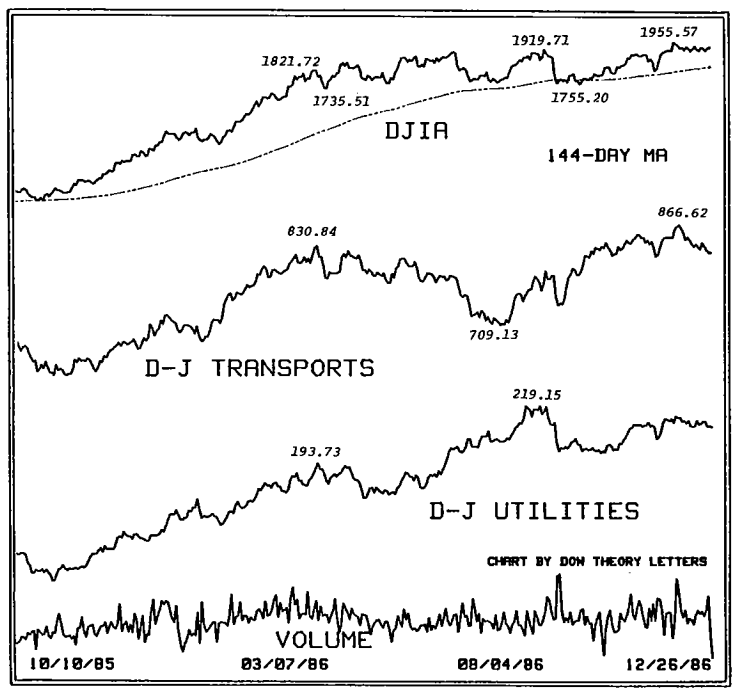
In the case of the 1986 market, we have had (no question about it) an erratic and difficult market. I might add that since price, as exemplified by the big stock averages, has been advancing during 1986, those of us who have held high-grade stocks (as I have consistently advised) did well. It was the people who held the medium- to lower-grade stocks who were frustrated, since the less than blue-chip stocks in general have not done well during 1986. Let's put it this way, if you held the Dow-type stocks in 1986, you were a hero, if you held the AMEX or NASDAQ stocks in '86, you were a bum.

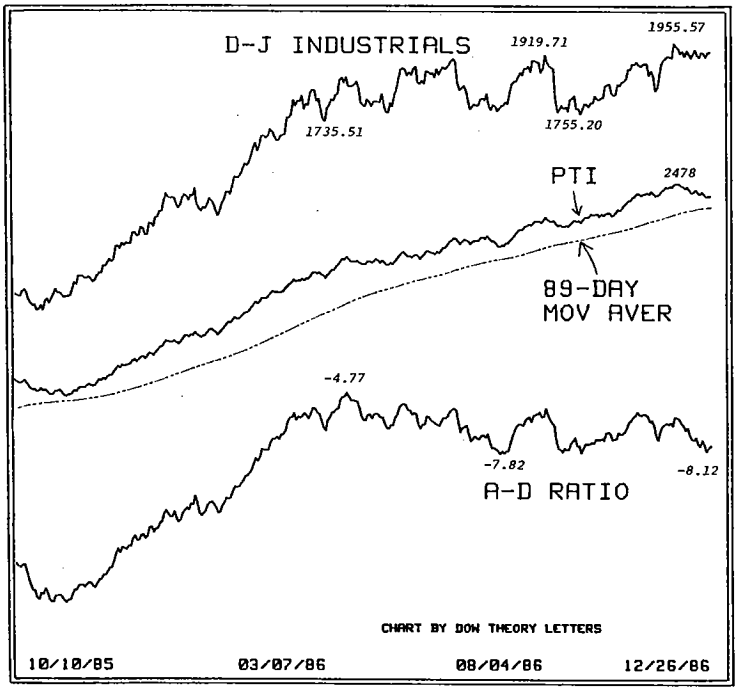
All right, now let's turn to the current technical picture. First, we must recognize that despite the strong showing in the big indices and averages (i.e, the Dow, the S&P 500, the NYSE Composite), there has been a definite divergence in this market ever since April 21. That was the day that marked the peak for the advance-decline ratio on the NYSE. Referring to the D-J Industrial Average alone, this most widely-followed of all averages has been advancing all through 1986. In fact, as late as December 2, the Dow rallied to an all-time high of 1955.57. That Dow high was confirmed by a record high of 866.62 in the D-J Transportation Average.

The problem is that since April 21, the A-D ratio has been trending sideways or down despite the powerful performance of the Dow. The divergence has now lasted for a period of over eight months. And the question is: how will the stock market ultimately RESOLVE this price/breadth divergence? Normally, when we see this kind of divergence, the technical problem is solved via a reaction (and occasionally by a full-fledged bear market). In most cases in the past, the reaction resulted in wiping out most or all of any gains that were made during the period of divergence.

If this type of resolution was to occur again, what could we expect on the downside? Here are a few benchmarks. On April 21 (when the divergence began) the Dow was 1855.90. Thus one possible resolution would be a decline that would take the Dow back to 1855.90. Second possibility: the lowest Dow point since April 21 was the 1755.20 level recorded on September 29. Therefore, it's possible that a price/breadth correction could take the Dow back to the mid-1700s.

So to review: In the past, when the Dow and the A-D ratio diverged, the usual outcome was downside action to or below the area where the divergent action began. And that's the possibility that is freezing the blood of so many market analysts today.





Are there any technical pluses in the current market picture? Yes there are, and I want to discuss a few of them. First, the price/breadth divergence described above has been going on for a LONG TIME, and by now almost everyone seems to be aware of it. When a situation (good or bad) becomes very widely recognized on Wall Street, it often aborts -- or it does not fully express itself. That could well be the case with the stock market today.

A second plus is that there is a great deal of cash on the sidelines today. For instance, fund cash (adjusted for the current level of interest rates) is now very high -- near the highest level ever. Such liquidity tends to be a bullish force for the stock market. Or to put it another way, market tops don't occur when the funds are cautious and loaded with cash.

Also highly constructive from a liquidity standpoint is the fact that customers' credit balances and margin debt on the NYSE are at record levels. Bullish trends in both of these indices (as is now the case) have almost always been associated with primary bull markets. Also in the liquidity corner, the Fed is in an accomodative mode. The Fed is making money very available, and this is always a positive for the stock market.

Another rather fascinating observation: Although the A-D ratio is currently near the bottom of its April-to-December range, the big averages and indices have really been remarkably STRONG. For instance, the S&P 500 and the Dow are now within a few percentage points of their 1986 highs. Despite eight months of lagging (diverging) breadth, the big stock averages have been extremely RESISTANT to decline. They just haven't wanted to follow the A-D ratio down.

There is a limit to HOW LONG the price/breadth divergence can last. I have a rule which I apply to the market and it goes like this: In a period of confusion, watch the WEAKEST element in the market equation. When the weakest element exhausts itself and finally turns up, the market is ready to advance.

In the current instance, the weakest element in the market has obviously been the A-D ratio. On December 23 the daily A-D ratio broke to a new low, its lowest level since the peak which it recorded last April 21. The new low in the A-D was NOT CONFIRMED by the Dow or, for that matter, by any of the major stock averages. In fact, the Dow would have to drop 160 points (below 1755.20) in order to confirm!

Thus we now have a major downside non-confirmation between price and breadth. Many important declines have reversed (to the upside) following price/breadth non-confirmations (Note: those who own my advance-decline albums can study examples of bullish downside non-confirmations in Dec. 1957, Sept. 1961, Oct. 1962, Nov. 1967, July 1970, Oct. 1972, Nov. 1976).

QUESTION: What about your Primary Trend Index?

ANSWER: All through 1986 (see page 2 chart) my PTI (despite the weak A-D) has remained in a bull trend. This is one of the things that has kept me bullish throughout the year. Even now the PTI is well above its 89-day moving average. This market is not going to head down in earnest until the PTI turns down and holds below a declining trendline (or until it holds below its moving average). That kind of bearish signal from the PTI has NOT yet appeared.

I might add that I don't think I've ever seen such a "difference of opinion" between the PTI and the A-D ratio. One of the reasons I invented the PTI back in 1971 is that I felt that somewhere in the future the A-D might gather too great a following (which might impair its usefulness). The PTI provided me with an alternative market gauge — for which I'm thankful.

QUESTION: Could some cyclical events be influencing this market?

ANSWER: For market cycles, I consider Peter Eliades' cycle work (Stockmarket Cycles, 2260 Cahuenga Blvd, LA, CA 90068) the best and certainly the most original that I have seen anywhere. In his latest December report Peter writes: "What do the cycles foresee for 1987? The answer is -- a spectacular advancing year for the Dow." But Peter cautions that the good times may not begin until February. He adds: "After February 16 of 1987, the last important cycle bottom should have been resolved, and the results should be remarkable." Just as encouraging, Peter reports that his 136-day oscillator of the daily advances (NYSE) is now down into the 770 area -- close to the low of 764 which was seen on September 17, 1985 (that low occurred one day before the Dow low, a Dow low that preceded the huge rise into 1986).

QUESTION: Russell, you noted at the opening of this piece that on December 2 both the Dow and the Transportation Averages rose to record highs. You stated that this action re-confirmed the primary bull trend. In view of this, could we still have a severe reaction or a bear market here?

ANSWER: You are really asking the question, "Does the December 2 re-confirmation guarantee higher prices or a continuation of the bull market?" The answer is that NOTHING IS GUARANTEED where the stock market is concerned.

Consider this: during the course of a bull market there will be MANY confirmations and re-confirmations. But there must eventually be a re-confirmation (no tree grows to the sky) which will be the FINAL re-confirmation -- following which a bear market will begin. In other words, every bull market must give ONE FINAL FALSE BULL SIGNAL prior to the onset of a change in the primary trend -- from bull to bear. So there is always a chance that the December 2 bull signal could have been the last re-confirmation. There is that chance.

Nevertheless, I keep coming back to my oft-stated thesis that we have not yet seen the final act in the drama. We haven't seen the public "take the bit in its teeth." We have yet to see the public run this market through the proverbial roof. I don't remember ever seeing or studying a major bull market that didn't ultimately get "crazy" via a public that finally rushed in shouting for hot tips and "stocks to double and triple." I don't think we've seen that kind of action yet. And I'm reasonably convinced that somewhere ahead it's going to happen. It may be six months or a year or three years -- but it's going to happen.

QUESTION: Russell, I note that most of the advisory services are offering their "forecasts for the coming year." Where are your forecasts?

ANSWER: I confess that I don't offer annual yearend forecasts,

not because I couldn't whip one up, but because I don't think they're worth much. Moreover, such forecasts can prove to be expensive, since a forecast implies a mind-set. And a mind-set in the stock market can leave you with patched pants and holes in your shoes.

What I prefer to offer is PROBABILITIES. And I'll let you in on a secret that I learned the hard way: anyone who offers more than probabilities where the stock market is concerned — is either a charlatan or an egomaniac.

Speaking of probabilities, "probably" the safest forecast (I should say the most logical one) is that the bull market will CONTINUE. I suggest that we be guided by the old Dow Theory thesis which states that a trend, once in force, will continue until proved otherwise (this observation, by the way, is most reliable when applied to the PRIMARY trend, less reliable when applied to the secondary trend and least reliable when applied to the minor or daily trend).

QUESTION: Russell, I read the papers and all I see is trouble . Reagan's in trouble, the economy's in trouble, the consumer's in trouble, the budget and our balance-of-trade is in trouble, the US auto business is in trouble, and that's just for openers. How can you have a bull market growing out of this morass?

ANSWER: Look at it this way. With all these troubles, the major averages are still within a few percentages of their all-time highs. Given that the primary trend of the market is up, it is fair to assume that things will get better in due time. If the averages are doing this well in the face of a sea of troubles, where will the market be when the clouds start breaking up?

Somewhere ahead, in a year, two years, three years (I don't know, and neither does anyone else) the sky is going to be bright blue, and the last clouds are going to disappear. At that point, my subscribers and I should be halfway through the exits. Because it's in that kind of atmosphere that bear markets are born.

INVESTMENT POSITION: The bull resides in the box. ... I spent the whole first section of this Letter discussing the divergence between the Dow and the A-D ratio. Now I want to discuss tactics and strategy. Please turn again to the page 2 chart. Note that during the entire period of divergence or ever since last April 21, my PTI HAS HELD IN A BULLISH TREND. I define a bullish trend in the PTI as a trend which finds the PTI climbing or at least holding ABOVE its 89-day moving average.

The PTI is based on the ACTION of eight critical indices and averages. The PTI is therefore not based on opinion, subjective analysis or on projections. It is based on what the market and its various components are actually doing. And I know from 15 years of experience that as long as the PTI is in a bull trend, the stock market will either climb or, at the very worst, hold together.

I have always used the PTI as my "fail-safe" indicator. I have written the following 50 times before, but I'll say it again for the benefit of new subscribers: MY POLICY IS ALWAYS TO STAY ON THE RIGHT SIDE OF THE PTI. In other words, if the PTI is in a bullish trend, I want to be in the market. If the PTI is in a bear trend, I want to be very defensive, which means being largely or completely out of the market.

Back in the last quarter of 1984 the PTI waffled above and below its moving average (MA). Finally, in January 1985 the PTI pushed above its MA; it's been holding above its rising MA ever since -- a period of roughly two years.

The PTI recorded an all-time high of 2478 on December 2, 1986, but since then it has dropped roughly 40 points. It is currently about 30 points ABOVE its MA. I am watching the PTI very carefully now, and I want my subscribers to know exactly what I see and what is occurring. If the PTI breaks DECISIVELY below its MA and then continues down below a declining MA, I am going to have to recommend selling, and maybe a good deal of selling. Remember, all this has not happened yet, but it could. I don't make the market, I only report on what I see. And as I said before, in this business you MUST have a fail-safe, an insurance plan which is designed to prevent disaster. The PTI is the fail-safe I use in these reports. If the PTI says "danger," I have no choice but to recommend moving largely to the sidelines as far as common stocks are concerned.

As a point of history, the last time the PTI broke decisively below its MA was in early-February 1984. The painful decline that followed lasted until July 24th of that year. Happily the 1984 reaction occurred within the context of a primary bull market. Eventually we are going to get a downtrend in the PTI that will represent the EARLY portion of a primary bear market. That is the decline I want to avoid at all costs.

There is only one way to avoid such bear markets. That is to pay the cost of insurance. (Insurance being a move to the sidelines once the PTI turns decisively down.)

In this business one absolutely MUST be able to change one's mind when the evidence presents itself. Thus, if the PTI breaks below its MA and starts tracing out a bearish pattern, I am warning my subscribers IN ADVANCE. Don't argue with the PTI, don't try to out-guess it, don't allow your own preconceived notions to interfere with the action that must be taken.

Remember this: the PTI's strength in 1986 (despite weakness in the A-D ratio) was the "technical glue" that kept this market going. **IF,** and I say **IF** the PTI (which was my strongest indicator) signals trouble in the period ahead, we're going to get trouble — plenty of it.

HOW TO MAKE A MILLION: Some months ago I revealed my philosophy for making a living. It consists of staying in my own business (which is publishing a market letter) and then investing my profits in other areas. Personally, I view those other investments as a SECOND BUSINESS. I stressed that I do not view investing as a fabulous new way to make a fortune. Neither do I look upon investing as a way to sit at home and get fat and rich. And I certainly do not look upon investing as a replacement for my publishing business. No, investing for me simply constitutes a relatively safe and intelligent path to a second income, or, as I view it, a "second business."

If subscribers could look upon investing as their own second business, I believe that philosophy, that approach, would serve them well. For the truth is that far too many people look on investing as the key to easy riches, or the path to some kind of financial paradise. As a result, they over-trade, they buy junk bonds that default, they purchase non-dividend-paying secondary stocks, and they completely miss the real point of investing -- the point being that investing is a way to create INCOME. Ultimately, if what you buy doesn't provide income, it isn't a true investment, it's simply hard-earned money going down the drain (with the single exception of tangible assets such as gold, platinum, jewelry, stamps, etc.).

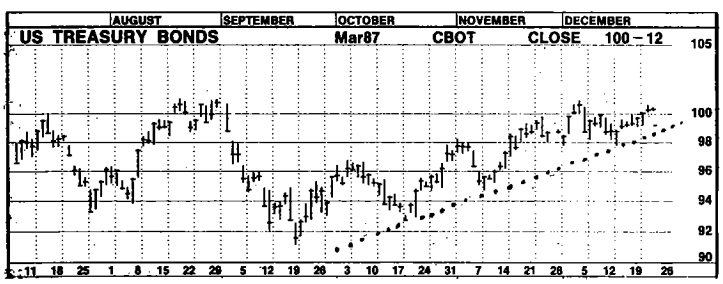
Some months ago my friend, Mark Skousen ("Forecasts and Strategies," 7811 Montrose Rd., Potomac, MD 20854) enlarged on this thesis, and I want to repeat a few of Mark's comments. First Mark noted that very few people become millionaires via the stock market. Rather, if they are fated to become millionaires, they do it in their own chosen field. Mark cites the following examples: (1) You don't become a millionaire by buying penny stocks. But conceivably, you might become a millionaire by SELLING penny

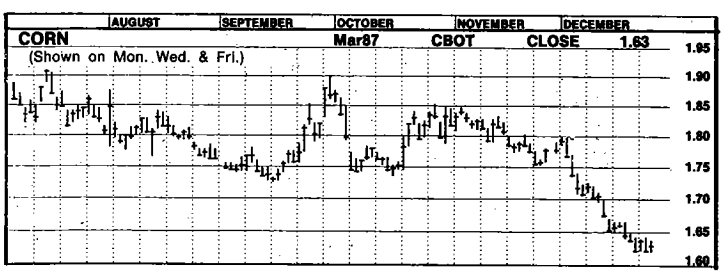
stocks as a broker (because brokerage is a business). (2) You don't become a millionaire by collecting rare coins. No, but you might conceivably become a millionaire by selling rare coins (because coin dealing is a business). (3) Very few people make millions buying real estate. But a lot of people make millions by becoming real estate agents or developers. By the same token, the commercial banks, savings and loans, and financial lenders make money (often millions) in real estate. Why? Because they are all running a business.

Anyway, I think you get the idea. The buyers, the traders, the collectors, they seldom make the big money. NO, it's the people who are in the business of selling these items who make the big money and the consistent money. Now I'm not saying that there aren't exceptions to this rule. I'm simply saying that most self-made millionaires made their millions IN THEIR OWN BUSINESSES. Actually, if you study the Forbes list of big-money people, you'll notice that the majority of these people either inherited their money or made their money by selling their own business to someone else (and, of course, that's where Malcolm Forbes himself accumulated his big bucks -- he inherited the business from his dad). (Sure, Malcolm improved the magazine immensely, but the point is that he started with the family business and took it from there.)

So my point is that people tend to have their real financial successes in the area that they KNOW BEST -- their own business. And I urge my subscribers to stick to that philosophy. Make your living from your job or your own business, and treat your investments as a second business and a source of pleasant, unearned income. Don't over-work your dollars, and don't throw them away in orgies of speculative nonsense. Make those dollars work for you the way a good solvent bank makes its loans and investments work for it. And by that I mean INVEST your hard-earned dollars in good INCOME-PRODUCING stocks and bonds, and then let those investments compound. If you never learn anything else from these Letters, this one concept should be worth the price of an annual subscription.

RATES: The dollar has turned weak again and crude oil is above 17 dollars a barrel, but so far neither event has worked to push US interest rates higher. This chart shows the T-bonds (Mar. contract) are in a definitive uptrend and near the upside breakout point. The talk is that the US economy is weak enough to warrant another discount cut in early 1987. The bonds say it's a possibility. ... Meanwhile, if there's any inflation in our future you don't see it in the charts of gold, copper, silver, lumber or any of the agricultural commodities. The CRB Commodities Futures Index is going nowhere, and if you're a farmer and corn is your main crop, you don't know what hit you.





NOTES & QUOTES: Surprise: It has been a given that Fed Chairman Paul Volcker would be replaced when his term is up next year. Now it's obvious that the Administration will NEED Volcker ("Mr. Integrity") a lot more than Volcker needs the Administration, particularly in light of the president's latest troubles centering around his own integrity. Volcker is guaranteed to get Wall Street offers of $2 million or more if he quits the Fed (vs. his current $73,000 salary). But insiders say that if Volcker is asked by the president to stay on, he will (Russell opinion: If Reagan has any brains, he will start writing love letters to Volcker immediately).

* *

It looks as if 1986 was Murphy's Law year in that anything that could go wrong went wrong in 1986. The latest: the pension fund safety net is tearing. The Pension Benefit Guarantee Corp. is the agency which is set up to insure a big share of pension plans (it insures 112,000 pensions covering 38 million workers). The PBGC has been ravaged by the troubles in the steel industry alone, and the fund now has a $2.5 billion deficit and a negative cash flow.

* *

U.S. Becoming a Tax Haven

New Laws May Make It World's Biggest Refuge

"The U.S. is on the verge of becoming the world's biggest tax haven; we're not talking Cayman Islands or Hong Kong here," said John Makin, chief economic analyst at the Washington-based American Enterprise Institute, contrasting the relatively small tax refuges elsewhere to the much

The LA Times seems to be the first newspaper to have discovered it: the US is becoming the world's leading tax haven. With Australia collecting 60% of all income over $22,000, with England at the 60% ceiling level, with Sweden at 80%, Japan at 70%, and West Germany and Canada at 55%, the new US tax ceiling at 28% (scheduled for '88) is drawing athletes, brains, and business geniuses from around the world (for more, see Letter 954, page 3 "Looking Ahead").

* *

Speaking of tax rates, I thought this chart would be useful to subscribers:

Tax-Exempt and Taxable Yields Compared

Tax-Exempt Yield	Taxable Equivalent Yield for Tax Rates of 28%	33%	35%	38%
5.5%	7.6%	8.2%	8.5%	8.9%
6.0	8.3	9.0	9.2	9.7
6.5	9.0	9.7	10.0	10.5
7.0	9.7	10.4	10.8	11.3
7.5	10.4	11.2	11.5	13.0
8.0	11.1	11.9	12.3	12.9
8.5	11.8	12.7	13.1	13.7

* *

Decade of the Glut: I thought this paragraph from Business Week's year-end review (Dec. 29) was worth pondering:

> If the 1970s were the years of shortage, then the 1980s are the era of gluts. From oil to grain and even to labor, the world is inundated with excess supply that should keep inflation in check. The industrial nations are also awash in a sea of liquidity, with more dollars, yen, and West German marks than they need to support the current level of business activity. Normally this excess money would start prices rocketing, but not when gluts abound. So the liquidity is spilling over into financial assets, like stocks and bonds, and sending the prices of these assets vaulting.

* *

Many of the brokerage offices are now doing up to 50% of their business in mutual funds. One attraction of the load mutual funds (and brokers, of course, want to sell the load funds rather than the no-loads) is that the brokers keep as much as 50% of the gross commissions vs. 25% to 35% for stock sales. But there's a

problem for a brokerage house that specializes in mutual funds. Once the fund gets the customer's money, that money tends to STAY with the fund. Consider this: When a stockholder gets scared, he sells his stocks, and that money goes back to the broker awaiting the next purchase. But when the fund-owner gets scared, he simply switches his equity fund to a money market fund -- that money stays with the fund, it never returns to the original stockbroker who sold the fund to the customer.

* *

What the heck, I may not be right, but I'm readable. Seriously, I want to thank Mark Hulbert (and I've given him a hard time in previous comments) for this recommendation. The clip appeared in the second biggest circulation newspaper in the nation, USA Today (Dec. 22):

News for the investor's mailbox

Suggestions from Mark Hulbert, editor of *Hulbert's Financial Digest*, a newsletter that tracks the performance of investment newsletters:

■ Most readable: *Harry Browne's Special Reports*, P.O. Box 5586, Austin, Texas 78763, 512-453-7313, $225 a year; *Dow Theory Letters*, by Richard Russell, P.O. Box 1759, La Jolla, Calif. 92038, 619-454-0481, $225 a year. Browne and Russell can wax profound on the philosophy of investing, Hulbert says. Their reports are "good to curl up in an armchair with and contemplate."

* *

The Japanese invasion of the US continues. The Japanese have been instrumental in running art prices through the roof, the latest example of which is a Rembrandt which sold in NYC for over $10 million (yes, that was for one small picture!). In real estate, the situation is just as wild. Exxon just sold its landmark NYC building to the Japanese for $610 million. During 1985-86 there were 150 major ($50 million or more) real estate deals involving the Japanese. Said the chairman of the big Sonnenblick-Goldman Corp (mortgage bankers) in NYC: "We're continually besieged by major Japanese companies and banks — they're in our office literally on a daily basis seeking investments in the real estate field."

* *

The Russell Over-Exposure Awards for 1986: I love John Madden's football commentaries. Then it was John and beer. And now, blast it, it's John Madden everywhere. That pudgy face and hoarse, shouting voice is taking over the airways. Give us a break, John. ... Runner–up is Fred Alger and the Alger Fund. Have you ever seen an ad campaign like this one? Two page ads everywhere -- in the newspapers, in Barron's, in the NY Times, and even in the staid Economist -- "How $10,000 invested with Fred Alger in 1965 would have grown to $651,228 over 21 years." C'mon Fred, betcha can't do that again, not twice in 42 years!

* *

Junk bonds: Led by LTV, 31 junk bonds lost a total of $3.1 billion in 1986, three times the 1985 amount. You think that's a lot? Wait until the next bear market. By the way, S&P downgraded 264 bond ratings in 1986, against 272 downgrades in 1985. For my subscribers: Buy A-rated or better bonds. I personally buy only AA or AAA.

* *

About a year ago we bought a batch of Stanford University bonds. The bonds are rated AAA, which is the same top rating as that enjoyed by the state of California. Why are the Stanford bonds so highly rated? For one thing, Stanford has a massive endowment of over $1 billion. For another, tuition to Stanford is over $17,000 per year! And speaking of colleges and universities, ponder these statistics. West Point and Annapolis (both free) last year accepted only 8.8% of their applicants. Next on the "hard-to-get-into" list were the following private colleges (all with tuitions above $17,000): Stanford, with an acceptance rate of only 14.2% of applicants, then Harvard with 16%, Princeton with 17.4%, Yale with 18.6%, Brown with 19.2%.

* *

The US has a new trading pattern. We import Toyotas, Jaguars, Danish silverware and Hong Kong electronics -- and we export bonds, billions of dollars worth of them. How long can this go on? Evidently, longer than any of us conservative cranks thought possible.

* *

In the Dec. 16 USA Today there appeared a fascinating interview with Sam Cummings, owner of Interarms, the world's largest private dealer in arms. I include a bit of this interview:

USA TODAY: You are a large private dealer in the world's arm sales. But how big are you compared with government operations?

CUMMINGS: In comparison with government, we're a joke. We are statistically the largest private trader. We move more weapons than anybody else. But 50,000 rifles won't buy a navigation assembly on an F-14 fighter. One modern fighter is $100 million — not quite that much, but a squadron is way over it. We have never had, in any year, a $100 million year.

USA TODAY: Is the U.S. government your competitor on items like those Soviet-made Kalashnikovs in your display case?

CUMMINGS: Yes, yes. Look at any pictures of the Nicaraguan "contras," of Angolan rebel Joshua Savimbi, of the Afghan rebels. They're all carrying Kalashnikovs. All of them are covertly supplied by the U.S. government. The U.S. government buys those Kalashnikovs through covert suppliers and pays two or three times what they could buy them for right here in Alexandria, for reasons that totally mystify us, frankly. We say, "Why are they doing that?" They know they are here. We have all the latest models and prices that are way, way below what the U.S. government pays.

USA TODAY: Are governments as heavily involved in black market and covert arms deals as they are in legal weapons trade?

CUMMINGS: Absolutely. And just as governments are responsible for 99 percent of all legal arms deals, they are responsible for 99 percent of the illegal arms deals.

fices in London. Is that the center of worldwide private arms sales?

CUMMINGS: For covert operations, I can't answer that. There isn't really any center for the legal arms trade. If you lean against any tree in Belgium, some fellow will fall out offering to sell you anything you want.

USA TODAY: Is that legal?

CUMMINGS: For the most part, but it's mostly talk. There are certain parts of the world where arms are promoted. We make it simple. We have a big depot for military weapons. If you want 20,000, 50,000 Kalashnikovs, go and look at them. If they satisfy you, test fire them at our range in the basement. If you like it and have an acceptable order from an acceptable government, take them. The price is the best in the world. Better than the East Bloc countries where they were made, in the case of the Kalashnikovs.

USA TODAY: Is that where you buy them?

CUMMINGS: I buy them in the East Bloc countries and, in some cases, in China. Wherever the market is best.

* *

I truly believe in karma. Karma is the belief that the good (or the bad) that you do comes back to you -- from a previous life, in this life, or in a future life. In other words, ultimately you get back what you give. I've often wondered about karma in relation to all the incredible multi-million dollar lawsuits that we read about these days. To me, most lawsuits (usually handled by shrewd, expert lawyers) are an indication of a failure to communicate, a failure to compromise, a failure to be fair -- or they are an indication of greed or the desire for revenge. Five million dollars awarded here, 15 million awarded there -- to me it's a sign of degradation and the collapse of morality.

* *

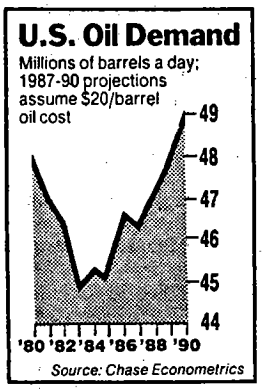
Jim Wright, future speaker of the House, came out a few weeks ago in favor of delaying tax cuts for the highest income brackets, which, of course, amounts to a tax increase. Tom Wicker (NY Times) has a way with words, and last week he wrote: "Like dogs with a bone or little boys with matches, Democrats can't seem to leave alone the idea of a tax increase. Just as some Republicans can't seem to get it through their heads that threatening the Social Security is political hari-kari, these Democrats seem to have a sort of death wish to raise taxes."

* *

Last year California (for the 38th year in a row) led the nation in agricultural products with receipts of $13.9 billion. And the big money maker here isn't oranges, it's dairy products with beef

second. The leading crops are cotton and then grapes. Oranges are a distant tenth. California produces 47% of the entire nation's crop of vegetables, 50% of the nation's fruits and nuts. California's biggest cash crop (not included in the statistics): marijuana worth $2.5 billion a year.

Speaking of agriculture, up to now farmers have grown whatever they LIKED to grow -- and then they looked for a market to sell it. That process has proved disastrous. The new trend: diversify, produce what the market wants. Successful farmers are now going into fish, shrimps, llamas, mushrooms, herbs, exotic vegetables, Kiwi fruit, etc. Today it's produce what the market wants -- or file for bankruptcy.



Surprise! Don't look now, but US demand for oil has been climbing ever since 1982. We may not be noticing it, but oil shares have, and this little chart shows why the oil stocks have been doing rather well lately (I have repeatedly recommended Exxon and Royal Dutch, both of which made new highs last week -- RD, by the way, accounts for 8% of all the oil and gas sold in the world). Oil consumption in the US has been growing at a rate of about 5% a year while domestic production has fallen off. In the third quarter of 1986 drilling dropped off 62% in the US compared with third quarter 1985. The Petroleum Industry Research Foundation says to watch for a major shock around 1989-90, at which time OPEC will supply about 50% of the free world's oil needs.

GOLD: Here we are entering 1987, and inflation is holding low, very low (probably below 3% on an annual basis). Furthermore, there's a world glut of almost everything, the stores and suppliers are bulging with merchandise from cars to steel, from corn to cows, from furs to fighter planes. Nothing is in scarcity, except, of course, common sense on the part of human beings.

Yet the price of gold has moved up from 284 in 1985 to almost 400 today. Why? Why should anyone be buying or holding the yellow metal (which pays no interest), and furthermore, why should anyone pay 37% MORE for gold today than they did two years ago?

All right, I'll try to provide an answer. I once discussed the problem of men and money with a buddy of mine who happened to be a psychoanalyst. And he said, "You know, Richard, ambitious and successful men and women are subject to fears and worries, just as you and I are. First they fear that they'll never make enough money. Then, once they've made the money (and they often dedicate their lives to making it), they fear that they'll lose it." That seemed such a simple and incisive observation that I stored it away in my cranium and never forgot it.

Consider this: We're talking about a wealthy man. He's got $50 million in liquid assets. He may have inherited it, but let's say he got it the hard way -- he made it himself. Now this guy is no dummy. He reads the newspapers, he reads the WSJ and Barron's and who knows, he may even read Dow Theory Letters. And last week he read a column by the New York Times' chief financial writer, Leonard Silk. I include a bit of that column below.

> THE year 1987 will confront the United States, Japan, West Germany and the other industrial countries with the necessity of finding solutions to the most dangerous set of problems that the world economy has faced since the end of the 1920's.
>
> Worries have intensified among economists and business executives that another breakdown in the system could happen. Yet, paradoxically, the securities markets remain strong, reflecting the widespread belief of investors that solutions can and will be found to the dangers that lie ahead. But skeptics may retort that stock market confidence also reached a high in 1929, just before the crash.

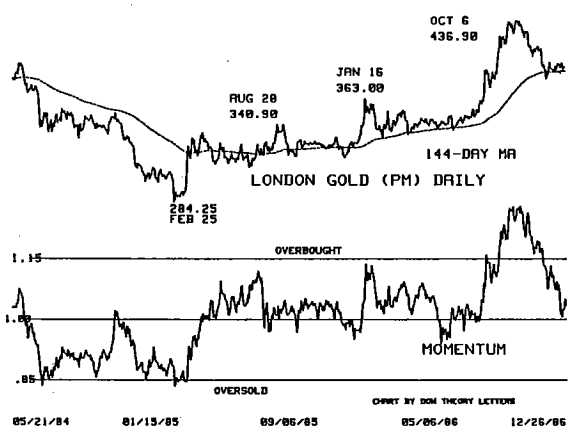
Our millionaire reads that column three times and he starts thinking. And he thinks thus: "Hmmm, I live pretty well, but I don't spend all the income from my $50 million. The good old USA has enjoyed good times for a lot of years now, but suppose we start having rough times? After all, the US standard of living has been pretty much held up by foreigners who have been buying our debt, but suppose, just suppose that they stop buying our debt? Or suppose a bear market hits, and all our great institutions start crumbling? Suppose things get out of hand on the downside? If that happens, our government is going to try to bail us (and, of course, itself) out via a flood of paper. If the government succeeds, the dollar is going to be worth far less in view of the newly produced ocean of paper. But if the boys in Washington don't succeed, there's a question of whether the dollar is going to be worth anything at all."

With that our bright millionaire picks up the phone and calls his broker: "Gus, get me a quote on 500 gold coins. That's right, 500, and I'm thinking of buying this same amount every month for the rest of the year. No, I don't care what they are, Kruggies, Maples, Kronas, just get me the best deal on the basis of gold content. Right Gus, and have 'em shipped to me care of my bank."

Sound far-fetched? Sound impossible? Not at all, it's happening right now -- all over the world. And as I see it, it's going to continue. Intelligent men know the value of insurance, and when or if the US or the global financial structure starts tearing apart at the seams, there's nothing more comforting (or valuable) than real money -- gold.

That's why gold pays NO interest. Interest is based on risk. Interest is the rent you receive for taking a risk. Buy a junk bond and they pay you 15% to hold it. Buy a top-rated bond and they only have to pay you 7%. Buy gold and they don't have to pay you a thing, because there's no risk of default, mismanagement, arson, thievery or anything else. Oh, and there's one other thing. Did you ever hold a handful of say 25 Maple Leaves? Take my word for it -- IT FEELS GOOD!

There's not too much to write about this week on the gold price action. Gold hasn't been doing much of anything over the last few weeks -- but as far as I'm concerned, in view of the fact that there's very little inflation, gold hasn't been going down. Now you may not find that interesting, but I do. And it's the end of the month, so I'm just about ready to buy my fixed dollar amount of Krugerrands or Kronas or Maples or what have you. When the premium on the American Eagle comes down, I'll be buying that one too.



The gold chart above is self-explanatory. Gold has pretty much corrected its momentum and the metal is now hugging its 144-day (exponential) moving average (MA). The MA now stands at 388. Gold is still bullish.

LATE NOTES: A listing of Important support levels: For the Dow the 144-day MA is now 1839. On my P & F chart the next important support for the Dow is 1900. For the S & P 500 next important P & F support comes in at 245. For the NYSE Composite next important support is 140.5.

NEXT MAILING: Jan. 14